

Why Not Eliminate Goodwill?

by L. Todd Johnson and Kimberley R. Petrone, Financial Accounting Standards Board

If the pooling-of-interests method of accounting for business combinations (pooling method) is to be eliminated¹ and the purchase method is used to account for all combinations, many have argued that any goodwill arising under the purchase method also should be eliminated—or at least that its effects on the income statement should be alleviated somehow. Doing so would temper the effects of eliminating the pooling method and constitute a major change in how the purchase method is applied.

Unlike the pooling method, the purchase method records the values actually exchanged in business combination transactions and the subsequent consumption or diminution of those values. Goodwill often is one of the most significant items recorded in accounting for those transactions, and it therefore is the lightning rod for objections to the purchase method. Those objections relate to the requirement to record goodwill as an asset and particularly to the requirement to amortize it against reported earnings in subsequent periods.

In its deliberations of the issues in the business combinations project, the Board considered an array of arguments that have been made for eliminating goodwill or alleviating its effects. Those arguments range from ignoring goodwill to keeping any charges associated with it out of the income statement or reporting measures of “cash earnings.” What did the Board conclude about those arguments?

“Goodwill Should Be Ignored”

The argument that goodwill should be ignored in accounting for business combinations is predicated on the notion that goodwill constitutes the primary difference (although not the only difference) between the purchase method and the pooling method. Thus, simply ignoring any goodwill that would be recorded under the purchase method would temper the effects of eliminating the pooling method.

The Board observed that although it might be possible to ignore goodwill in some business combinations, goodwill cannot be ignored in all of them. That is, goodwill might be ignored in combinations in which the acquiring company’s

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Arguments for eliminating goodwill (or alleviating its effects on the income statement) and the Board’s conclusions about them:

- *Goodwill should be ignored*—Goodwill cannot be ignored in cash transactions, only in stock transactions, which would create discontinuities in the purchase method.
- *Goodwill is not an asset*—Although goodwill itself is not exchangeable, it meets the assets definition in Concepts Statement 6.
- *Goodwill is not reliably measurable*—Although goodwill is not as reliably measurable as some assets, it is capable of being measured with sufficient reliability.
- *Goodwill is not a wasting asset*—Much of goodwill is “wasting” and thus must be amortized; moreover, because impairment testing cannot be relied on as the sole means for measuring the portion that is not “wasting,” recourse must be made to amortization.
- *Goodwill amortization is arbitrary*—Goodwill amortization can be less arbitrary and more reliable if it is based on a careful assessment of the underlying elements of goodwill.
- *“Cash earnings” should be reported*—Reporting measures of “cash earnings” involves issues that are well beyond the scope of the business combinations project and would have to be addressed in a future project; however, goodwill charges should be made more transparent, with an earnings subtotal being reported that excludes those charges and per-share measures being permitted.

¹The reasons for the FASB’s decision to eliminate the pooling method are discussed by the authors in another Viewpoints article, “Why Eliminate the Pooling Method?” FASB Status Report No. 316, August 31, 1999.

stock is the consideration by not measuring the full value of the consideration exchanged. However, the full value of the consideration exchanged cannot be ignored in transactions in which cash is the consideration. The entire cash outlay must be accounted for and, as a result, something else must be recorded if goodwill is not—either another asset was acquired or the acquirer overpaid (and thus a loss was incurred). Thus, ignoring goodwill only in transactions effected by stock would produce discontinuities in how the purchase method is applied.

Moreover, one of the reasons that the Board concluded that the pooling method should be eliminated is because the nature of the consideration tendered should not dictate the accounting for the net assets acquired. Ignoring goodwill in stock transactions and recording it in cash transactions would be inconsistent with that reasoning. Instead, it would be a “back-door” means of effectively retaining part of the pooling method and thus it would suffer from many of the same deficiencies.

Furthermore, the Board observed that ignoring goodwill could result in unearned gains being recorded in subsequent periods. For example, the sale of a company for \$100 million that had been purchased for \$100 million (but only recorded at \$60 million due to eliminating goodwill of \$40 million) would lead to reporting a \$40 million gain—even though only the original outlay was recovered. Alternatively, if the company were sold for \$90 million, a \$30 million gain would be reported—even though a \$10 million loss was incurred.

“Goodwill Is Not an Asset”

Instead of simply ignoring goodwill, another argument is that goodwill should be eliminated because it is not an asset. Proponents of this view argue that goodwill should be written off immediately upon acquisition, with the write-off bypassing the income statement by being taken either directly to equity or to “other comprehensive income” (OCI), either of which investors might ignore. Alternatively, some argue that the write-off could be reported in the income statement as a one-time charge, which investors also might ignore or weigh less heavily than other income statement items.

According to this argument, goodwill does not meet the definition of an asset because it cannot be sold separately from the acquired business. Moreover, recording goodwill as an asset assumes that because a cost was incurred, an asset must have been acquired, thereby mistakenly equating costs with assets.

To ensure that the accounting standards that it issues are cohesive and consistent, the Board looks to its conceptual framework for guidance. “Assets” are defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*, as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. The Board concluded that goodwill provides future economic benefits

because it possesses the capacity—in conjunction with other assets—to produce cash flows, and also concluded that the business combination is the past transaction that results in control of those benefits by the entity. In reaching those conclusions, the Board noted that Concepts Statement 6 specifically indicates that exchangeability is not a necessary characteristic of assets. The Board agreed that incurrence of costs does not necessarily result in acquisition of assets but observed that those costs provide evidence that assets may have been acquired.

The Board further noted that writing goodwill off on the basis that it is not an asset could also result in unearned gains being reported in subsequent periods, such as when an acquired company is subsequently sold at a price less than its cost to the acquirer (as illustrated in the earlier example related to ignoring goodwill).

“Goodwill Is Not Reliably Measurable”

A somewhat different argument concedes that goodwill may meet the assets definition but asserts that goodwill is capable of being measured reliably only at the date of the business combination. Accordingly, goodwill satisfies the criteria for being recognized as an asset only upon its acquisition and not afterward. Thus, even if goodwill is recorded as an asset, it should be written off immediately afterward, and the write-off should be taken directly to equity or OCI, or to the income statement as a one-time charge. The net effect therefore would be the same as writing goodwill off immediately upon acquisition on the grounds that it does not meet the assets definition.

The Board acknowledged that measuring goodwill subsequent to its acquisition is more difficult than measuring many other assets. Goodwill must be measured initially as a residual, the excess of the purchase price of the target company over the fair value of its identifiable net assets. Because a similar residual measure usually is not available subsequent to the date of acquisition, goodwill is not as readily measurable as, say, assets that are exchangeable and for which there are observable and active markets. However, the Board observed that similar difficulties arise with other assets that are not exchangeable or for which there are no observable or active markets, such as specialized equipment, yet those assets are not written off immediately. Instead, they are accounted for and management is held responsible for the investment made in them.

The Board further observed that goodwill often constitutes one of the most significant assets obtained in the acquisition of a company. If the transaction is conducted at arm's length between parties that are independent of one another, the transaction price presumably reflects the values exchanged. As such, the value of the consideration tendered and the value of the net assets acquired in exchange—including goodwill—should be equal. Because that goodwill has value on the date of exchange, it also should have value immediately afterward (absent a catastrophe or similar subsequent event). Moreover,

as discussed previously, writing goodwill off could lead to reporting gains in subsequent periods that have not been earned. Accordingly, the Board concluded that goodwill should not be written off immediately following its acquisition.

“Goodwill Is Not a Wasting Asset”

Another argument also concedes that goodwill meets the assets definition but asserts that it is not a wasting asset, that is, its value does not decrease over time like buildings and equipment. Instead, many argue goodwill is a valuable asset that maintains its value—and commonly increases in value—over time. As such, goodwill should not be amortized at all but rather should be written down only when deemed to be impaired. Alternatively, if testing goodwill for impairment is not feasible and recourse must be made to amortization, they argue that the amortization charge should be kept out of the income statement by charging it either directly to equity or to OCI.

The Board conceded that there is some merit to the view that goodwill may not be a wasting asset but observed that what is recorded as goodwill may include other things that are not “true goodwill.” For example, the amount recorded for goodwill may include identifiable intangible assets that were not separately recognized because their value was not determinable (or, if recognized, were undervalued) but that are wasting assets. Alternatively, the amount recorded for goodwill may reflect an undeterminable overpayment for the target company—which is not an asset at all. Moreover, many elements of what constitutes true goodwill, such as the assembled management team and work force, do not have indefinite lives. At best, therefore, only part of what is recorded as goodwill may in fact be a nonwasting asset, and thus not amortizing goodwill would not be representationally faithful.

In addition, testing goodwill for impairment is fraught with difficulties. Impairment tests are based on the future cash flows that an asset is expected to produce, but goodwill alone does not produce cash flows. Instead, it produces cash flows in conjunction with other assets or groups of assets. However, associating goodwill with those assets for purposes of impairment testing is problematic, particularly when the operations and activities of once-separate companies are combined.

As a result, goodwill may have to be assessed on an enterprise-wide basis, which also is problematic. For example, the cash flows generated by the purchased goodwill would be commingled with those produced by the acquiring company’s other assets, including its internally generated (but unrecorded) goodwill, thereby muddying the analysis. Alternatively, goodwill may be allocated to smaller cash-generating units for purposes of testing, but such allocations may be arbitrary and thus not very meaningful. The field tests that were conducted on some of the Board’s proposals for accounting for goodwill supported the view that impairment testing might not prove to be workable in many cases.

Moreover, the future cash flows associated with goodwill extend many years into the future, particularly if at least part of goodwill is in fact a nonwasting asset. Reviewing goodwill for impairment based on undiscounted cash flows, as called for under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, therefore would not be appropriate because all of those cash flows would be given the same weight, regardless of whether they related to the first year or the hundredth year.

For all of those reasons, the Board concluded that impairment testing could not be relied on as the sole means of measuring goodwill subsequent to its acquisition. Instead, amortization is the only viable alternative since developing an operational impairment test that is robust is not generally possible. Thus, the Board concluded that goodwill should be treated as a wasting asset and acknowledged that its amortization can at least in part be seen as compensating for a less than fully effective impairment test.

“Goodwill Amortization Is Arbitrary”

Yet another argument concedes that goodwill may be a wasting asset but asserts that its useful economic life and pattern of consumption or diminution generally are not known or knowable. Applying any “systematic and rational” method of amortization therefore produces accounting results that are arbitrary, particularly if the maximum amortization period is to be reduced from the present maximum of 40 years to 20 years. Thus, goodwill amortization adds “noise” to the income statement in the form of inaccurate—or perhaps even unnecessary—charges against earnings that can be confusing to investors. That problem is compounded in cases in which goodwill amortization charges are combined with other expenses in the income statement (and goodwill is combined with other assets in the balance sheet) and users of financial statements cannot assess them on their own merits. The “noise” can be overcome by simply excluding all goodwill amortization from the income statement by writing goodwill off immediately and taking the charge directly to equity, to OCI, or to the income statement as a one-time charge. Alternatively, if goodwill must be amortized, the periodic charges should be taken directly to equity or to OCI in order to avoid adding “noise” to the income statement.

The Board agreed that the amount of goodwill amortized each period may be somewhat arbitrary. However, the Board observed that goodwill amortization would be less arbitrary and more reliable if it were based on a careful assessment of the elements that underlie the purchased goodwill. Information about those elements may be gleaned, for example, from documents underlying management’s decision to undertake the

acquisition of the target company and to pay a premium for it. Moreover, the Board noted that decreasing the maximum amortization period from 40 years to 20 years for goodwill (which is an “unidentifiable asset” and thus more ambiguous) was accompanied by eliminating the corresponding 40-year maximum for many other intangible assets (which are “identifiable assets” and therefore less ambiguous).

The Board agreed that greater transparency of goodwill and goodwill charges is essential to facilitate the analysis of financial statements. However, the Board noted that taking those charges directly to equity would not lead to greater transparency. It also would not be consistent with Concepts Statement 6 because those charges do not reflect investments by owners or distributions to them, which are the only items that can be taken directly to equity.

The Board also disagreed with taking those charges to OCI for several reasons. One reason is that taking those charges to OCI raises conceptual issues that go beyond the scope of the business combinations project. Those issues include what the basis might be for including those charges in OCI, whether and on what basis they should be “recycled” into the income statement, and whether goodwill impairment charges also should be taken to OCI. Another reason is that virtually all companies report OCI in the statement of changes in equity, which is a statement that attracts less investor attention than the income statement and thus would make the goodwill charges less transparent.

“Cash Earnings’ Should Be Reported”

Yet another argument is that the problems associated with accounting for goodwill under the purchase method necessitate reporting measures of “cash earnings.” Such measures have been promoted by a number of companies and have gained some prominence among analysts in recent years, as well as attention in the business and financial media. However, some observers have noted that companies promoting such measures often have little or no earnings to report.

Moreover, what is meant by “cash earnings” varies widely. For example, some interpret it as a measure like “earnings before interest, taxes, depreciation, and amortization” (EBITDA); others interpret it as a measure of earnings that excludes adjustments that stem from applying the purchase method; still others interpret it as earnings before amortization of either intangible assets generally or only goodwill; yet others interpret it as some form of “free cash flow.” That has led some observers to assert that “cash earnings” is a misnomer because those measures do not reflect either cash or earnings.

The Board considered the argument that some measure of cash earnings should be reported in conjunction with business combinations but noted that doing so raises a number of other issues. For example, should a measure of cash earnings be required only in conjunction with business combinations or should it also be required for companies not engaging in business combinations so that financial statements will be comparable? Given the wide variety of ways in which cash earnings is interpreted, which measure or measures should be required? Should cash earnings be considered only in the context of the income statement, or should cash earnings be considered more broadly, thereby possibly including reconsideration of the cash flow statement as well? After some consideration, the Board concluded that those issues were well beyond the scope of the business combinations project and thus would have to be considered in a future project.

The Board did, however, consider how the charges for goodwill amortization and impairment should be reported in the income statement. In doing so, the Board observed that goodwill is unique among assets and that goodwill charges are unique as well. The Board also noted that many of its constituents have widely differing views about how to account for and report goodwill and goodwill charges. Moreover, many investors appear to weigh goodwill and goodwill charges differently from other assets or other income statement charges in their analysis of financial statements.

For those reasons, the Board concluded that goodwill and goodwill charges should be reported differently from in the past. Specifically, the Board concluded that goodwill should be reported as a separate line item in the balance sheet and that goodwill charges should be reported as a separate line item in the income statement. Furthermore, to facilitate understanding of their cash consequences, those charges should be reported on a net-of-tax basis. Additionally, the amount for goodwill charges should be preceded by a subtotal that reflects income before those charges (as well as before other items that are reported on a net-of-tax basis, such as discontinued operations and extraordinary items). The Board also concluded that per-share amounts may be presented on the face of the income statement for both that subtotal and for the amount of goodwill charges; however, presentation of those per-share amounts would not be mandatory.

That proposed treatment has led some observers, including members of the business and financial media, to believe that the Board is proposing that a measure of cash earnings should be reported. However, that observation is incorrect because excluding goodwill amortization does not necessarily produce “cash earnings.” One reason is that the Board’s proposal only applies to business combinations and therefore does not

address other items that some believe should be excluded from “cash earnings,” such as depreciation expense. Another reason is that the proposal is limited to goodwill charges and thus does not extend to other noncash income statement charges stemming from application of the purchase method, such as the amortization of previously unrecorded intangible assets acquired or the additional depreciation related to step-ups in the bases of tangible assets acquired.

As noted above, the Board may at some future date comprehensively consider the issues associated with reporting earnings. That might come in a project that reconsiders the form and content of the cash flow statement, the income statement (including reconsideration of the presentation of OCI), or both. However, the Board will have to consider the need for such a project on its own merits and weigh its relative priority in comparison with other possible new projects that are also competing for the Board’s resources and attention.

Conclusion

As indicated above, the arguments for eliminating goodwill or alleviating its effects in some way range from ignoring it entirely to keeping any charges associated with it out of the income statement or reporting measures of “cash earnings.” The Board gave careful consideration to those arguments but observed that many of those arguments—if accepted—would tend to produce accounting results that are more like those produced by the pooling method. However, the Board concluded that the pooling method should be eliminated because, unlike the purchase method, it does not provide investors with information about how much was invested in a business combination and the subsequent performance of that investment, of which goodwill is a significant component.

The Board also observed that many of those arguments are based on the view that goodwill generally equates to the acquisition premium over the book value of the target company’s net assets. That view effectively assumes that the book values of the net assets acquired approximate their fair

values and that no other identifiable assets were acquired (or liabilities assumed or incurred) as part of the business combination. However, such an assumption is a mistaken one in most cases, and goodwill typically represents only part of the acquisition premium.

In reaching its conclusions about goodwill, the Board noted that the views of its constituents about how goodwill should be accounted for are many and varied. Board members themselves have different views on those issues—in contrast to their unanimous agreement that the pooling method should be eliminated. Accordingly, the Board acknowledged that there may be no “silver bullet”—that is, no perfect answer to the difficult question of how goodwill should be accounted for—that will satisfy everyone.

The Board’s conclusions about those issues are not yet final and thus are subject to change, depending on what it learns during the next steps of its due process. The Board’s proposals, including those for eliminating the pooling method and not eliminating goodwill, are detailed in the FASB Exposure Draft, *Business Combinations and Intangible Assets*, which has been issued for public comment. That Exposure Draft has a comment deadline of December 7, 1999, which will be followed by public hearings in early February. In light of the problems that the Board encountered in addressing how goodwill should be accounted for, it particularly urges its constituents to express their views (and the reasons underlying them) on its conclusions with respect to goodwill.

L. Todd Johnson is a senior project manager at the FASB. Kimberley R. Petrone is a project manager at the FASB. The views expressed in this article are those of Mr. Johnson and Ms. Petrone. Official positions of the FASB are determined only after extensive due process and deliberations.